PERNAS OTIS ELEVATOR CO SDN BHD

v.

SYARIKAT PEMBENAAN YEOH TIONG LAY SDN BHD & ANOR

HIGH COURT MALAYA, KUALA LUMPUR
RAMLY ALI J
[SUIT NO: D5-22-2220-1998]
23 JULY 2003

CONTRACT: *Building contract - Retention sum held by employer - Whether main contractor liable to pay subcontractor retention sum by virtue of subcontract - Interpretation of "pay when paid" clause - Whether liability only arises when main contractor receives payment from employer - Whether subcontractor could challenge architect's certificate authorizing deduction of retention sum*

The plaintiff was the subcontractor in a project involving the construction of a hotel. The defendants were the main contractors of the said project. The subcontract between the said parties provided, *inter alia*, for the contract price in the sum of RM5,900,000 and a retention sum of RM300,000. One half of the retention sum was to be released after the architect issued the Certificate of Practical Completion ('CPC'). The remaining half was to be released upon the issue of the Certificates of Making Good of Defects ('CMGD'). The subcontract also provided that payment should be made within seven days after the defendants received the same from the employer of the project. The plaintiff completed the works under the subcontract but was not paid the whole amount due. The architect of the project deducted the retention sum of RM300,000 upon complaint by the consultants of the project of some problem therein. The plaintiff denied the complaint made by the said consultants but alleged that the problem could be solved by the employer involving the costs of RM167,500 only. The plaintiff commenced this action against the defendants for the retention sum of RM300,000 or in the alternative the sum of RM132,500 being the balance after deducting the said RM167,500.

The issues: (1) whether the defendants were liable to the plaintiff in respect of the sum claimed; and (2) whether the architect was wrong in certifying a deduction of RM300,000.

Held:

[1] Clause 2.3 of the subcontract provided that all payments in respect of any work, material or goods comprised in the subcontract which include payments of the retention sum under cl. 2.2 must be made within seven days after receipt of the same by the main contractor from the employer of the project. Clause 2.3 was the "pay when paid" clause and the defendants were not liable to pay the plaintiff retention sum unless and until they had received the same from the employer. The intention of cl. 2.3 was also evident from the plaintiff's own minutes of discussion leading to the subcontract which indicated that the defendants were only obliged to pay the plaintiff within seven days of receipt of the same from the employer. The facts showed that the defendants had not received the sum of RM300,000 or any part thereof from the employer. It followed that the defendants could not be held liable to pay the plaintiff under cl. 2.3 of the subcontract. (pp 39 e-h & 40 a-c)

[2] If the plaintiff felt that the retention sum should not have been held by the employer based on a wrong architect's certificate, the plaintiff could invoke cl. 11(d) of the subcontract and take the matter to arbitration under the name of the defendants or jointly if necessary with the defendants. (p 44 f)

[3] Even if the architect's certification was wrong, the defendants had no power or authority to authorize the architect to re-certify, amend or change the certificate. The defendants were not liable for any wrongful certification made by the architect. Unless there was manifest error on the face of the architect's certificate, the courts usually do not enquire as to whether the certificate was issued in accordance with the terms and conditions of the contract. Nevertheless, the plaintiff could invoke cl. 11(d) of the subcontract by taking the matter to arbitration. (p 45 a-d)

[4] The architect's certificate was valid and binding on all parties and until and unless the defendants received the monies from the employer, the plaintiff had no claim against the defendants for the amount deducted by the employer. Otherwise it would mean that the plaintiff was demanding from the defendants to pay a sum that had not been certified by the architect against the rules in the building contract. The accuracy of the architect's certificate was for the arbitrator to decide as provided under cl. 11(d) of the subcontract. (p 45 f)

[Plaintiff's claim dismissed.]

Case(s) referred to:

Brightside Mechanical & Electrical Series Group Ltd v. Hyundai Engineering & Construction Co Ltd [1988] 1 CLJ 714; [1988] 2 CLJ (Rep) 712 HC ***(refd)***

Hong Kong Teakwood Works Ltd v. Shui On Construction Co Ltd [1984] HKLR 235 ***(refd)***

Interpo Engineering Pte Ltd v. Sin Heng Construction Co Pte Ltd [1998] 1 SLR 694 ***(refd)***

Schindler Lifts (Hong Kong) Ltd v. Shui On Construction Co Ltd 29 BLR 98 ***(refd)***

Other source(s) referred to:

S Bickford Smith & E Freeth, *Enden's Building Contracts and Practice*, 8th edn, p 86

For the plaintiff - Paul Chong; M/s Paul Chong & Nathan
For the 1st defendant - Jason Chua Han Seng; M/s Dorairaj Low & Teh
For the 2nd defendant - Ida Fazlina; M/s Nordin Torji & Yusof Ahmad

Reported by Usha Thiagarajah

JUDGMENT

Ramly Ali J:

The plaintiff's claim is pursuant to a Subcontract No. TB/814/L&M/M&E/LIFT/056 dated 15 June 1990 wherein the plaintiff had agreed for the supply, delivery, testing, commissioning and maintenance during defects liability period of lifts and escalators including all accessories and incidental works as specified for the proposed International Class Luxury Hotel known as Hotel Istana.

Brief Facts

The defendants were the main contractors in a joint venture project involving the construction of a proposed hotel known as Hotel Istana. The plaintiff was a subcontractor to the defendants by virtue of a written subcontract dated 15 June 1990 for the supply, delivery, commissioning and maintenance during defects liability period of lifts and escalators including all accessories and incident works. The employer of the project was one Pernas One (KL). The employer employed Juruukur Bahan Malaysia (JUBM) as the Consultant Quantity Surveyors; Ranhill Bersekutu Sdn. Bhd. as the Mechanical and Electrical Consultants; and Daya Bina Arkitek (M) Sdn. as the architect for the project.

The terms of the subcontract, *inter alia*, are as follows:

(a) the contract price is for a sum of RM5,900,000;

(b) there shall be a retention sum of 5% from the contract price ie, RM300,000;

(c) the subcontract period shall be (72) weeks commencing on 18 Jun 1990;

(d) the progress payment will be made monthly at the rate of 75% of equipment on site or 90% of the valuation of completed works;

(e) one-half (2 1/2%) of the retention sum can only be released after the Certificate of Practical Completion (CPC) has been issued by the architect;

(f) the remaining one-half (2 1/2%) of the retention sum will be released to the subcontractor (plaintiff) upon issue of the Certificates of Making Good of Defects (CMGD) when all warranty obligations have been fulfilled; and

(g) payment in respect of any work, material or goods comprised in the subcontract shall be made within seven (7) days after receipt by the main contractor from the employer.

There is no dispute that the plaintiff has completed the works as stipulated under the Subcontract. However, Ranhill Bersekutu as the Mechanical and Electrical Consultant for the project appointed by the employer, complained that the lifts installed by the plaintiff has caused excessive harmonic distortions which as affected the electric flow system in the project. On that ground, Ranhill Bersekutu instructed Juruukur Bahan Malaysia, the Consultant Quantity Surveyors for the project appointed by the employer, not to release the last 2 1/2% of the retention sum amounting RM300,000 to the plaintiff. Consequently, Daya Bina Arkitect, the Architect for the project, also appointed by the employer, deducted the said sum of RM300,000 from the amount to be paid to the plaintiff.

The plaintiff denies the allegation made by Ranhill Bersekutu about the problem of excessive harmonic distortion. In any event, according to the plaintiff, the problem can be solved by the employer involving costs of RM167,500 only. Therefore, the plaintiff is claiming for the said sum of RM300,000 or in the alternative, the sum of RM132,500 (being the balance sum after deducting RM167,500); plus interest at the rate of 8% p.a. from the date of filing of this action until full satisfaction.

Plaintiff's Arguments

The plaintiff argues that by virtue of cl. 2.3 of the subcontract, the defendants are liable to pay the plaintiff when the plaintiff has completed the works. The plaintiff further argues that the defendants are under a duty of care to ensure that whatever deduction certified by the architect is correct and also to ensure that the balance of the retention sum after being correctly deducted be paid by the employer through the defendants to the plaintiff. According to the plaintiff, the plaintiff as a subcontractor has no privity of contract with the employer

and any deduction made by the employer by way of Certificates of the Architects, is entirely between the defendants (as main contractor) and the employer. The plaintiff further argues that the deductions made by the architect do not fall within the ambit of cl. 2.3 of the contract and it cannot be implied.

The plaintiff also argues that under cl. 2.2 of the subcontract the retention sum is to be released upon issuance of CPC and CMGD. The conditions for the release of the retention sum, according to the plaintiff, is that upon the issuance of the CPC and CMGD, the retention sum must be released or paid to the plaintiff. Further, the plaintiff argues that cl. 2.2 does not provide for any condition that for the release of the retention sum there must be actual receipt of payment of the same from the employers by the defendants.

Defendants' Arguments

The defendants on the other hand argue that:

(i) the defendants owe no duty of care or responsibility towards the plaintiff as alleged by the plaintiff;

(ii) the plaintiff's claim does not allege any breach of duty or contract by the defendants;

(iii) under the terms of the subcontract, the defendants have paid over to the plaintiff all sums they received from the employer and as such the defendants have discharged their obligations under the subcontract;

(iv) the plaintiff has by its conduct dealt directly with the employer and/or its consultants during the subsistence of the subcontract and thereafter had assumed the responsibility for the rectification of the "excessive harmonic distortion" of the lifts and the finalisation of accounts with the employer and/or its consultants;

(v) pursuant cl. 2.3 of the subcontract, the defendants are not liable to pay the plaintiff as claimed, as they have not received payment of the sum from the employer.

Issues To Be Determined

The parties have agreed on the following issues to be determined by the court namely:

(i) whether the defendants are liable to the plaintiff in respect of the sum claimed, which sum was a deduction certified by the architect, Daya Bina Architect (1st Issue); and

(ii) whether the architect, Daya Bina Architect was wrong in certifying a deduction of RM300,000 and if so, whether the defendants are liable to pay the said amount to the plaintiff as claimed (2nd Issue).

1st Issue

The relevant provision in the subcontract relating to this issue is cl. 2.0 (particularly cl. 2.3), which reads:

> 2.0 Terms of Payment
>
> 2.1 Progress Payments will be made monthly at the rate of 75% of equipment on site or 90% of the valuation of completed works. The limit of the retention fund shall be 5% of the total contract price.
>
> 2.2 One half (2 1/2%) of this retention can only be released after the Certificates of Practical Completion ("CPC") has been issued by the Architect.
>
> Upon issue of the Certificates of making good of defects when all warranty obligations have been fulfilled ("CMGD"), the remaining 2 1/2% will be released to the Subcontractor.
>
> 2.3 Payment in respect of any work, material or goods comprised in the Subcontract shall be made within seven (7) days after receipt by the Contractor from the Employer.

Clause 2.3 clearly provides that all payments in respect of any work, material or goods comprised in the subcontract which obviously include for payments of the retention sum under cl. 2.2 must be made within seven (7) days after receipt of the same by the main contractor (the defendants) from the employer. Clause 2.3 is usually known as "pay when paid" clause. In other words, the defendants liability or obligation to pay the plaintiff only arise upon the defendant having received the same payment from the employer. The defendants are not liable to pay the plaintiff unless and until the defendants have received the same from the employer.

The intention of this cl. 2.3 is evident from the plaintiff's own minutes of discussion leading to the subcontract. The minutes read as follows:

> The contract to be signed between you and us shall be based on PAM NSC Form **except** that payment shall be made to us by you within 7 days from date of your **receipt of payment from the owner**
>
> It must be highlighted that this minute was to be substituted in place of Clause 11(b) which provided that "... within fourteen days of receipt by the Contractor of any certificate or duplicate copy thereof from the Architect, the Contractor shall notify and pay to the Subcontractor the total value certified therein ...

a We would require that the right of Subcontractor to suspend execution of Subcontract work, as provided for under Clause 11(e) of PAM NSC Form be extended to include the **event of default in payment by the owner**.

The literal interpretation of the relevant minutes of discussion clearly indicates that the parties thereto have agreed that the defendants were only obliged to b pay the plaintiff within (7) days of receipt of the same payment from the employer. The fact of the present case shows that the defendants have not or did not receive the sum of RM300,000 or any part thereof from the employer because the employer retained it as certified by the architect, Daya Bina Arkitek, upon valuation by Juruukur Bahan Malaysia and upon recommendation by c Ranhill Bersekutu. A plain reading of cl. 2.3 as well as the relevant minutes of discussion and the fact that the defendants have not received the money (RM300,000) from the employer, clearly point to the fact that the defendants cannot be held liable to pay the plaintiff under cl. 2.3.

d The court as well as the learned counsels for both sides are not able to locate any reported Malaysian case law on the interpretation of "pay when paid" clause as in cl. 2.3 of the subcontract. Therefore, the court has to find guidance somewhere else in order to interprete the real meaning of the said cl. 2.3 ie, the "pay when paid" clause.

e Generally, payments to subcontractor from the main contractor are governed by cl. 11(b) of the PAM NSC Form under the PAM Forms of main contract 1966, which reads as follows:

> (b) Within fourteen days of the receipt by the Contractor of any certificate or duplicate copy thereof from the Architect the Contractor shall notify f and pay to the Subcontractor the total value certified therein in respect of the Subcontract Works and in respect of any authorized variations thereof and in respect of any amounts ascertained under Clause 8(c) hereof less:
>
> (i) Retention Money, that is to say the proportion attributable to the g Subcontract Works of the amount retained by the Employer in accordance with the Main Contract; and
>
> (ii) The amounts previously paid.

However, in the present case, it was modified as appears in cl. 2.3 of the h subcontract based on the minutes of discussions of the parties as stated earlier. For the purpose of convenience, the court shall refer to the said cl. 2.3 as the "pay when paid" clause.

i

Mr. Robert Jewkes in the article *"Sub-Contractors Under Threat: A Personal View"* as appeared in *The International Construction Law Review* vol. 5, January-October 1988, viewed a similar clause commonly used in Hong Kong as a "provision to protect the main contractor against the risk of insolvency of the employer." To him, this was a fair and sensible provision because the nominated subcontractor was normally selected by the employer or its agent the architect and the payment of the nominated subcontractor was more or less guaranteed by the employer." The relevant clause which Mr. Jewkes examined was cl. 11(b) of the "Green Form" (used in Hong Kong) which provides:

> Within five days of the receipt by the Contractor of the sum included in any certificate of the Architect, the Contractor shall notify and pay to the Subcontractor the total value certified therein in respect of the Subcontractor works less certain agreed deduction.

On close scrutiny the courts finds that the above provision of cl. 11(b) of the Green Form" is different from the provision of cl. 11(b) of our PAM NSC Form. In our PAM NSC Form, there is no element of the contractor "to pay the subcontractor upon receipt by the contractor of the sum" from the employer or owner. Clause 11(b) of our PAM NSC Form only states that the contractor shall notify and pay the subcontractor within 14 days after receipt of any certificate from the architect the total sum certified in the certificate. On the other hand, the provision in cl. 11(b) of the "Green Form" (as used in Hong Kong, according to Mr. Jawkes's article) relates more to the "pay when paid" clause ie, the contract shall pay the subcontractor within five days of the receipt by the contractor the sum included in the certificate of the architect.

What Mr. Jewkes was trying to impress in his article is that the "pay when paid" clause, as commonly used in Hong Kong, policy wise is an acceptable practice among the subcontractors and main contractor in the related industry. It is not an oppressive one-sided clause. It serves to protect the main contractor in the event the employer is not able to pay for the works done for whatever reason.

The courts in Singapore and Hong Kong have had occasion to examine the "pay when paid" clause.

In *Brightside Mechanical & Electrical Series Group Ltd. v. Hyundai Engineering & Construction Co. Ltd.* [1988] 1 CLJ 714; [1988] 2 CLJ (Rep) 712 (Singapore High Court), the employers in a building contract agreement declined to make payment to the defendants (main contractors), holding the money due to be set off against liquidated damages to be paid for delays. The defendants (main contractors) in turn declined to the plaintiff (subcontractor)

the sum of S$924,711 certified as payable to the plaintiff (subcontractors). It was the defendants' contention in that case that as they had not received any money from the employer, they were not liable to pay anything to the plaintiff (subcontractor). The defendants relied on cl. 11(b) of the subcontract which reads:

> Within five days of the receipt by the Contractor of the sum included in any Certificate of the Architect the Contractor shall notify and pay the Subcontractor the total value certified therein in respect of the Subcontract works ...

Thean J held:

> *Prima facie*, Clause 11(b) contemplated the actual receipt by the Main Contractor of the sum included in the certificate and that until the Defendants received from the owner the sum claimed by the Plaintiffs they were not obliged to pay it to the Plaintiffs. In this case there was no actual receipt by the Defendants of the amount certified by the Architect.

In *Hong Kong Teakwood Works Ltd. v. Shui On Construction Co. Ltd.* [1984] HKLR 235 (Hong Kong High Court), the same issue was dealt with by the High Court in Hong Kong. In that case, the plaintiff was a subcontractor of the defendant and claimed the amount due under two Architect's Certificates issued. The plaintiff claimed to be entitled to summary judgment under the two certificates and appealed against the dismissal of its O. 14 application. Clause 11(b) of the relevant subcontract provides that "within 14 days of receipt by the main contractor (the defendant) of payment from the employer against any certificate from the architect, the main contractor shall notify and pay to the subcontractor the total value certified therein." In that case, the building owner (the employer) had failed to pay the defendant the amount certified because the employer had set off against these certificates an amount arising from a claim for liquidated damages for delay under the main contract. The issue arising under cl. 11(b) of the subcontract was what constitutes "receipt ... of payment from the employer". The learned judge, Hunter J in considering the issue held:

> I think that I must give these words their normal meaning. To me their usual meaning is receipt of actual payment, receipt of money ... I think that all these words contemplate a simple piece of arithmetic, and that the *prima facie* meaning of receipt of payment is receipt of money.

In another case, *Schindler Lifts (Hong Kong) Ltd. v. Shui On Construction Co. Ltd.* 29 BLR 98, the facts are similar to that of the *Hong Kong Teakwood* case above. The plaintiffs were subcontractors to the defendants who were the main contractors. By letters dated 20 December 1983 and 2 March 1984, the employer gave notice to the defendants that they were setting off sums stated

to be due to the defendants under the certificate against liquidated damages. By reason of this set-off, the plaintiffs did not receive cash payment due to them. The defendants, invoked cl. 11(b) as a reason for not paying the plaintiff. Clause 11(b) in that case was the same as that cited in the *Hong Kong Teakwood* case. The Court of Appeal Hong Kong relied on the learned judge's judgment in the *Hong Kong Teakwood* case in that the subcontractor was only entitled to receive payment if the main contractor was paid by the employer.

In *Interpo Engineering Pte. Ltd. v. Sin Heng Construction Co. Pte. Ltd.* [1998] 1 SLR 694 (Singapore High Court), one of the issues to be determined was whether cl. 7 of the subcontract was a "pay when paid" clause and if so, what was the effect of the clause. The said cl. 7 of the subcontract provides:

> (1) As and when a progress payment for Main Contractor work is received by (the Defendants) from (Tavica), (the Defendants) shall promptly cause it to be banked into (the Defendant's) bank account and shall immediately upon its clearance issue a cheque in (the Plaintiff's) behalf thereof (hereinafter called the 'net sum');
>
> (ii) (The Plaintiff's) entitlement to payment of the net sum each time shall arise progressively as and when a progress payment or NSC sum including the retention sum, is received from Tavica by the (Defendants) and (the Plaintiffs) shall issue an official receipt to (the Defendants) for each and every payment received.

The learned judge in that case was of the view that cl. 7(ii) was reasonably straight forward and unambiguous. The plain meaning was that the plaintiffs were not entitled to any progress payments unless such payment are received by the defendants from Tavica (the employer).

From the foregoing authorities, it is clear that the law as it stands at present, the courts in Singapore and Hong Kong have given the words "receipt of payment" their literal normal meaning. In other words – they refer to "receipt of actual payment, receipt of money." As a result the main contractor incurs no liability to pay the subcontractor until he actually receives payment in the physical sense from the employer. In our present case, the effect of cl. 2.3 of the subcontract is the same. Clause 2.3 is clear and unambiguous, in that the defendant (the main contractor) is only liable to pay the plaintiff (the subcontractor) when the defendant had received the said payment or sum from the employer and the payment to the plaintiff must be made within seven days after the receipt of the said sum by the defendant. There is no reason why this court should not follow the same interpretation as that of the courts in Singapore and Hong Kong over the said provisions. In coming to the above decision, the court has to consider the interest of the main contractor as well

as the interest of the out-of-pocket subcontractor; the freedom of contract and the fact that contracts may differ from case to case. A "pay when paid" clause in one contract may be worded differently from another. Clauses such as cl. 2.3 in our present case, are common industry clauses, which must be accepted by the parties with the knowledge of the attendant risks. The problem arises only when the employer fails to pay the main contractor. Parties (main contractors and subcontractors) are free to negotiate their contracts and agree to whatever terms in the agreements or contracts unless they are prohibited by law. While the courts will readily wrap a caring arm around the weak and the week, they cannot do so in every instance. Everyone negotiates his own contract. He is at liberty to give and take as much as he can mutually agree with the other side. The subcontractor *per se* is not a special species which requires special principles of law to give him a generous dose of legal protection.

In the present case the subcontractor is not without any remedy. As has been said earlier, the retention sum was held by the employer (and not paid to the defendants) based on the certificate certified by the architect on the recommendation of Ranhill Bersekutu. Clause 11(d) of the subcontract clear provides:

> If the Sub-contractor shall feel aggrieved by the amount certified by the Architect or by his failure to certify then, ... the Contractor shall allow the Sub-contractor to use the Contractor's name and if necessary will join with the Subcontractor as claimant in any arbitration proceedings.

Therefore, if the plaintiff feels that the retention should not have been held by the employer based on a wrong certification by the architect, then the plaintiff should invoke the mechanism provided under cl. 11(d) of the subcontract and the defendants are duty bound under the clause to allow the plaintiff to use its name and if necessary to join as co-claimant.

In light of the foregoing the court's answer to the 1st issue must necessarily be in the negative.

2nd Issue

The 2nd issue to be determined is whether the architect, Daya Bina Arkitek was wrong in certifying a deduction of RM300,000 and if so, whether the defendants are liable thereof.

In his cross-examination, DW1 stated that, in projects of these nature where an architect is employed by the employer, all parties are bound by the Architect Certificate. Throughout the project, the employer has been making payments to the plaintiff through the defendants based on the amount certified by the architect in his certificates. The defendants also are duty bound to pay the plaintiff in accordance with the architect certificate.

The architect was employed by the employer and for all intents and purposes was the employer's agent and not the defendants'. Therefore, even if the architect's certification was wrong the defendants have no power or authority to authorise the architect to recertify, amend or change the certificate. The defendants are not liable for any wrongful certification made by the architect.

Unless for manifest error on the face of the architect certificate, the courts usually do not enquire as to whether the certificate was in fact issued in accordance with the terms and conditions of the contract. This has been clearly stated in *Enden's Building Contracts and Practice* (8th edn p. 86) by S. Bickford Smith & E Freeth, an authority in building contracts, as follows:

> A certificate must be in the form stipulated by the Contract. But provided it is good on the face of it, the Court will not enquire whether it was infact issued in accordance with the contract conditions.

In the present case, even if the certificate is wrong and the plaintiff does not agree to it, the plaintiff can invoke the mechanism provided under cl. 11(d) of the subcontract (as cited earlier) to have the certificate withdrawn, amended, recertified or reissued by taking the matter to arbitration under the name of the contractor (where the contractor (the defendant) is duty bound to allow) either on its own or jointly, if necessary, with the contractor (the defendant). This is the only available option to the plaintiff with regards to the architect certificate. This has not been done yet.

When the architect certificate is issued, it is valid and binding on all parties and until and unless the defendant received the monies from the employer, the plaintiff has no claim against the defendant for the amount deducted by the employer. Otherwise, the plaintiff is actually demanding from the defendant to pay the plaintiff a sum that has not been certified by the architect which is against the rules in the building contract. The issue as to whether the architect certificate is accurate or not is for the arbitrator to decide as provided under cl. 11(d) of the subcontract.

Decision

For the reasons above, the court finds that the plaintiff has failed to establish its claim against the defendants, on the balance of probabilities. Under cl. 2.3 of the subcontract the plaintiff is not entitled to the payments claimed as there is no evidence to show that the defendants have received such payment from the employer. Therefore the plaintiff's claim against the defendants is dismissed with costs.